Internal Revenue Service

memorandum

CC:TL-N-2815-88
Br1:CEButterfield

date: MAR 2 1988

to: District Counsel, [redacted] CC:[redacted]

from: Director, Tax Litigation Division CC:TL

subject: [redacted]
Undocketed Status

This responds to your January 19, 1988 request for technical advice.

ISSUE

Whether the method used by [redacted] to account for proceeds from the sale of slops is acceptable for tax accounting purposes. 0471-0100.

CONCLUSION

We believe that the method used by [redacted] to account for the slops would very likely be found to be acceptable for tax purposes. In addition, the alternative methods for which [redacted] might argue in litigation would be as likely to lose revenue as generate it. Therefore, the hazards of litigation justify conceding this case.

FACTS

[redacted] (formerly [redacted]) is in the business of manufacturing and selling [redacted] Whiskey. The whiskey is produced from grain, which is ground and heated to produce "mash," the sugars from which ferment to produce the alcohol which is distilled and aged, and becomes whiskey. Once the alcohol has been removed from the grain mixture, the spent stillage (slop) is piped out of the mash tub into a cooling tank, and then disposed of by sale as cattle feed. The taxpayer claims, and we apparently do not dispute, that from each [redacted] pounds of grain, [redacted] pounds end up in the slop. Costs of disposing of the slop consist of depreciation on the holding tank and pump, and employee salaries for supervising the distribution to farmers.

In the Appeals Supporting Statement, the Appeals Officer makes reference to a [redacted] Article discussing the history of slop disposition at the [redacted] plant. The article was written to discuss [redacted] discontinuing the sale of slop. The article discussed the history of disposition by [redacted], pointing out that originally the substance was distributed the local farmers free, as a convenient way to dispose of waste. Later it was sold for $[redacted], then $[redacted] per thousand gallons, to recoup expenses of disposition. The availability of such a high quality free or inexpensive cattle feed caused cattle farming to flourish in the area, and caused local land prices to rise. The discontinuance of sales of the slop was apparently due to environmental damage by the cattle. [redacted] switched to "dry housing" the grain, as a less expensive method of disposition, in [redacted]. This history, which we have no reason to doubt, indicates that originally the slop was residual waste from the whiskey production process.

For both tax and financial reporting purposes, [redacted] accounts for proceeds from the sale of slop by entering proceeds less costs of disposition in a Spent Stillage account. At the end of the reporting year, the account is zeroed out by allocating sufficient costs of production to it to reduce the balance to zero. The costs of production for the whiskey are thereby reduced by the amount of net proceeds from the sale of slop, and net proceeds from the sale of the aged whiskey, four or five years distant, will be accordingly higher. Thus taxes will be paid on the amount attributable to the sale of slop, but through lowering the cost of goods sold, and raising the net revenue, from the sale of whiskey, after a deferral of four of five years.

The Revenue Agent auditing [redacted]'s fiscal [redacted] and [redacted] years included in those years proceeds from sale of slop less costs of disposal. The agent allowed none of the pre-split-off costs of production to reduce the proceeds. He also made no adjustment to the open inventory for those years, to replace the reductions already made attributable to the same proceeds. Thus the agent has included revenue from the sale in the current year, without removing it from the year of whiskey sale. The Appeals officer assigned to the case felt rather strongly that no change in accounting practice was warranted in this case, and recommended conceding the issue. Taxpayers have made it clear that they will not accept less than a full concession, and that if the issue is litigated they will assert as an alternative position that [redacted]% of the costs of production (the percentage of the grain that ends up in the slop) should be allocated to the slop as a joint product, resulting in a large net loss on the sales for both years.

The adjustment for [redacted] was $[redacted], and for [redacted] was $[redacted]. Tax deficiencies attributable to these amounts were paid by [redacted], and a refund was requested. The refund was originally conceded by Appeals. The amount of the refund ($[redacted]) was sufficient to require Joint Committee review, and was submitted to them. The Committee criticized the Service's concession of the issue and recommending that it be submitted to Corporation Tax for technical advice. The Corporation Tax Division responded by concluding that issue should not be conceded. Appeals submitted it again with a proposed supporting statement conceding the issue, and Corporation Tax once again recommended that the Agent's conclusions be upheld, and that the refund be denied.

You have requested our advice from a litigation standpoint, because you agree with Appeals that this is a very poor litigating vehicle, and probably should be conceded. We have consulted with the Corporation Tax Division, and they advised us, as they advised you, that they would have no objection to the concession of this case based on litigation hazards. Based on those considerations, we concur with your opinion that this case is ripe for concession.

LEGAL ANALYSIS

There is relatively little law in the area of by-products accounting, even less on the precise issue of whether proceeds from sale of a by-product may be applied to reduce the cost of producing the main product, and not taken into current revenue. From a strict technical point of view, it may well be that there is no mechanism in the Code that can be said to authorize a taxpayer to defer the accrual of revenue through such a device. The courts, however, to the extent that they have ruled at all, indicate that such methods are proper.

The facts in this case suggest that if slop had achieved by-product status (from its former status as waste) by [redacted] and [redacted], it had done no more than that. We do not believe that we could be sustained in the assertion that slop is a joint product of the whiskey. Therefore there is a rational appeal to taxpayer's method, in that it reflects the reality that the proceeds are essentially a reduction in the cost of disposition of spent raw materials, reducing the cost of such materials, with a consequent reduction in the cost of production. Should taxpayer elect to emphasize the fact that slop was originally distributed without charge, it will detract from our assertions in the eyes of the court.

I.R.C. § 471 requires that when inventories are necessary to determine the income of any taxpayer, they shall be taken in such method as the Secretary may prescribe as clearly reflecting income, and in accordance with the best accounting practice of the industry. Corporation Tax has advised you that their position on this issue allows for no exceptions, whether or not an item is material. Some courts have taken a different view. Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781 (11th Cir. 1984); cf All-Steel Equipment, Inc. v. Commissioner, 54 T.C. 1749 (1970). In this case the percentage of sales represented by sales of slop is less than one-half of one percent. Therefore under the Knight-Ridder reasoning the taxpayer would not be required to use an inventory for the item.

A threshhold question under section 471 is whether the Service may disturb the taxpayer's inventory method if the method is in accordance with Generally Accepted Accouting Procedures (GAAP), accurately reflects income, and accords with the best standards of accounting used by the industry. Arguably, the taxpayer's method meets all these requirements. Substantial precedent would indicate that under these circumstances the Service may not require that the taxpayer change to another method of accounting, even though that method may be more accurate than the one used by the taxpayer. Monfort of Colorado, Inc. v. United States, 561 F.2d 190 (10th Cir. 1977). Similarly, the Commissioner's discretion under section 446 to redress perceived distortions of income is not unlimited. That is, numerous cases have held that in spite of the Commissioner's broad discretion to direct the method of accounting used by a taxpayer, without sufficient justification the Commissioner may not require a change from one allowable method to another, even a better, method. RCA Corp. v. United States, 664 F.2d 881 (2d Cir. 1981), cert. denied 102 S.Ct. 2958 (1982); see also, Note, Protecting the Public Fisc: Fighting Accrual Abuse With Section 446 Discretion, 83 Colum. L. Rev. 378 (March 1983), and cases cited therein.

If there is no distortion of income, therefore, or the amount involved is not material, there are precedents that would preclude the Commissioner from requiring a change in method. One of the arguments that has been raised to demonstrate the existence of a distortion of income is the deferral that results in the recognition of income under the taxpayer's method. That is, revenue from the sale of slop is not recognized as income until the related whiskey is sold five years later. Although deferral of recognition is a basis for finding that a method is improper (the burden might well be on the taxpayer, after all, to demonstrate under section 451 what justifies their not recognizing income that they have clearly received) the mere existence of a five year lapse of time is probably not sufficient to create a distortion. For example, in United States v. Hughes Properties, ___ U.S. ___, 106 S.Ct. 2092 (1986), a case which involved the issue of whether or not a casino could deduct the amount shown on the face of a progressive slot machine at the end of the year even though that amount had not yet been won, the Court did not appear to be dismayed by the fact that the lapse of time between deduction and payout could be as much as four years. Therefore a lapse of five years, without more, probably will not justify a finding of distortion.

Assuming, on the other hand, that a finding of distortion is not neccessary, or that a distortion exists in this case, so that the Commissioner has the authority to scrutinize the method used by the taxpayer, we must look at the hazards of asserting in litigation that the taxpayer's method is impermissible, and that the method asserted in the notice of deficiency should be applied in its place.

Section 471 generally requires inventories where they are necessary to clearly reflect income. The Regulations are somewhat more specific, although they are not explicitly instructive on this point. Treas. Reg. § 1.471-1 states that in order to reflect income, inventories are necessary in every case in which the production of merchandise is an income-producing factor. As stated above, there is a judicial exception for merchandise that does not produce income in material amounts. In addition, although we do not know how relevant a court would find it, taxpayers are not making a direct reduction in costs of production by net proceeds from sale of slop. Instead they do maintain an account into which the net proceeds are entered. This account is then closed at the end of the year by the entry of an offsetting amount of costs of production. The existence of an account for slop revenue, albeit a nominal one, may be significant for the determination of compliance with the regulations.

Section 1.471-2 of the regulations requires that each inventory must conform to the best accounting practice in the trade, and it must clearly reflect income. The regulation states that inventory rules are not uniform, but give effect to trade customs in an industry, and grant a great deal of weight to the consistency with which a particular method is used by the taxpayer. Section 1.471-2 of the regulations is limited in that even though a method may meet its two requirements, it must still be in accord with Treas. Reg. §§ 1.471-1 through 1.471-11. Given the percentages involved, we do not imagine that a court would find a distortion of income in the method used by the taxpayer. Moreover, the taxpayer has asserted that its method of accounting for the sale of slops is common throughout the distillery industry.

Charles T. Horngren, in Horngren, Cost Accounting A Managerial Emphasis (3d Edition, Prentice-Hall, 1972), discusses the proper methods for accounting for by-products. (We would note that the advice from Corporation Tax appears to conclude that the slop is a joint product. We think it is more properly categorized as a by-product, if it is not still a waste product.) By-products are generally defined as products with minor sales value as compared to the that of the major product.

Horngren states that the distinction between by-products and scrap is very difficult to establish, but that the best treatment of net realizable value from the sale of by-products or scrap is as a deduction from the cost of the main product. This reflects the reality that such products (particularly the slop in this case) are not an intentional result of the production process, but an unavoidable one, and that their sale for some immaterial amount is more a method of reducing costs than of generating income. Although this analysis may not be equally applicable for tax purposes, where the general rule is that income must be recognized when received, a court may find the analysis appealing on the facts of this case, where such small percentages are involved. Furthermore, Horngren indicates that the method used by the taxpayer is the best treatment for by-products or waste products.

Bulloch, Keller and Vlasho, in Accountants' Cost Handbook A Guide for Management Accounting (3d Edition, Wiley & Sons, 1983) discuss the distinction between by-products and scrap. They state that when the value of the product is minor and is recoverable without further processing it is generally known as waste. Since the slop would have to be pumped out of the mash tub and cooled whether it was sold or otherwise disposed of, and is not otherwise subject to processing, it falls within this definition. The distinction between scrap, by-products, and joint products may be of limited relevance from a strict technical point of view, under the Code, but we believe the court will find it relevant to the issue of whether inventories are required at all.

Assuming that we prevail in our assertion that the slop is subject to the inventory requirement, the next hurdle is the allocation of costs to it to arrive at a value for inventory. Section 1.471-7 of the regulations states that a taxpayer engaged in manufacturing who derives two products by a single process the unit costs of which are substantially alike may allocate costs to each product to absorb the aggregate costs, as long as the allocation is reasonably related to the selling prices of each item. Section 1.471-11 of the regulations details the allocation of direct and indirect costs of production to inventories. Section 1.471-7 of the regulations does not literally capture the situation at hand, where the unit costs of the two products are not substantially alike, and the application of that section begs the question of whether or not the slop is actually subject to the inventory requirement. Neither section lends support to our argument that the slop should be inventoried, nor do they bolster taxpayer's argument that the slop need not be. They do address the issue of the value to be assigned, if the slop is to be included in inventory, although they leave room for alternative valuations.

Taxpayer does maintain an account for slop, including in it the net revenue. At the close of the year they allocate enough costs of production to reduce the account to zero. On its face, this method falls within the literal requirements of the regulations. The taxpayer has stated that in the alternative, if they are required to put the slop in an inventory account, they will allocate costs of production to inventory in proportion to the amount of raw materials which remain in the slop after the alcohol is removed. This will result in a substantial net loss for each year, as [redacted]% of the grain remains in the slop. Analyzed on the basis of incremental costs, the slop is sold at a profit. That is, the cost of disposition is more than recaptured by the revenue received. We could argue that were this not so, the taxpayer would not sell the slop; they would not incur incremental costs for disposition that made the sale uneconomical if they could merely dispose of it as waste less expensively. However, the taxpayer must pump the slop out of the mash tub whether or not the slop is actually sold. The incremental costs incurred solely because of the sale may be limited to those costs incurred for the loading of slop onto the trucks of the farmers who purchase it, and a certain amount of loading costs would be incurred merely to get the slop hauled away as waste. In point of fact, however, the taxpayer more than recovers the post-split-off costs from the revenue obtained in selling the slop.

The Agent allocated no costs other than the costs of disposition in deriving the deficiencies for the two years in question. He did not allow allocation of any pre-split costs. Nor did he adjust the whiskey inventory to reflect the fact that the costs of production had already been reduced by the net revenue he attributed to the two years under review. The taxpayer has argued for allocation of sufficient productions costs to the slop to result in a large net loss. This allocation would probably be found to contradict the requirement of Treas. Reg. § 1.471-7 that cost allocations bear some reasonable relationship to the sale prices of the items. Corporation Tax has recommended the application of a method which allocates production costs between the whiskey and the slop in proportion to their net realizable values. This method would allow the allocation of an additional small percentage of the joint production costs to the slop.

The allocation of the appropriate percentage of joint production costs, as well as the post-split-off costs, to the slop would further reduce the deficiency asserted in the notice. Corporation Tax would not argue that the taxpayer was entitled to allocate none of the joint production costs, which is apparently what the Agent did in reaching the deficiency amount. There are few cases on the issue of allocation of costs between products. In the depletion context courts have three times considered Service challenges to methods employed by taxpayers, and in each case have permitted the taxpayer to continue with their allocation undisturbed. Woodward Iron Company v. Patterson, 173 F. Supp. 251 (N.D. Ala. 1959); PPG Industries, Inc. v. Commissioner, 55 T.C. 928 (1970); Monsanto Company v. Commissioner, 86 T.C. 1232 (1986).

We believe that the allocation proposed by Corporation Tax is the most rational, and bears the strongest relationship to the relative sales prices of the two products, thus it has the weight of the 471 regulations behind it. However, the application of this method would require allocation of more costs of production to the slop than were applied by the Revenue Agent, reducing the amount of the deficiency (you would know better than we by how much), and magnifying the de minimus aspect of this case. In addition the amount of net proceeds previously deducted from costs of production would have to be replaced in a section 481 adjustment, which would have the effect of reducing income by an offsetting amount in the year of whiskey sale.

General principles of tax accounting certainly favor the approach adopted by Corporation Tax. I.R.C. § 451; Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). However, the pursuit of this case in litigation would raise a high risk of generating an opinion that vindicates the use of the taxpayer's method accross the board. If we wish to preserve the argument that inventories are required for by-products and that revenues must be accounted for currently rather than being used to reduce costs of production we should bring a case in which the product is intentionally produced, and generates more than 1% of total revenue. An adverse decision in this case would open up the use of the method of reducing cost of production by net proceeds from by-products to other industries where the by-products are intentionally produced, rather than merely incidental to production of the main product, as is the case for slop. Even if the court were to require the use of inventories it is far from certain that they would allocate costs to produce a net gain on the sale, and even if they were to do that the deficiencies in [redacted] and [redacted] will be substantially offset by reductions in income for the years in which the related whiskey was sold.

In sum, the hazards of litigating this case are great. The revenue effects may very well be negative, and the possibility very real that the resulting opinion will have a wider detrimental effect on revenue. Therefore, even though the taxpayer's method may not be in strict compliance with the inventory requirements, we concur with your opinion that the case should be conceded.

If you have any questions with regard to this matter, please do not hesitate to contact Ms. Clare E. Butterfield, at (FTS) 566-3442.

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